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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 001561

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SUBJECT: SCENESETTER FOR SPECIAL ENVOY MORNINGSTAR'S VISIT
TO MOSCOW

Classified By: Ambassador John R. Beyrle for Reasons 1.4 (b/d)

OVERVIEW

¶1. (C) Embassy Moscow warmly welcomes your visit to Russia, which provides an opportunity for us to engage with the highest levels of the Russian government on energy issues, an opportunity that has until recently been largely absent in the relationship. The "reset" of relations and in particular President Obama's July visit has opened doors for us that had been closing for years and that slammed shut last year after Georgia. Our goal should be to use this opportunity to voice our support for a robust Russian energy sector that is fully integrated into the global economy and that operates under modern and competitive best business practices. The GOR's control of the energy sector is at the root of most of our concerns -- from Russia's troubled energy relations with its neighbors to the lack of competition and inefficiencies that result in a sector that is unresponsive to the global energy market. We are unlikely to alter significantly the GOR's control of the sector. However, your meetings can help us to get a better sense of the GOR's actions and plans and make clear the importance of keeping things moving in a positive direction. The economic crisis and the gas glut are also likely to help our cause. However, despite a continuing decline in the real economy, the steep rebound in oil prices in the last several weeks has restored some of the GOR's swagger. End summary.

BACKGROUND

¶2. (SBU) A roller-coaster year of oil and gas price spikes and plunges, and sharp economic contraction, has not changed an elemental truth: Russia is still the world's largest producer and exporter of hydrocarbons. With recent record-high prices and vast potential for further exploitation, the sector was one of the drivers of the rapid growth of the Russian economy in recent years. However, the global financial and economic crisis exposed the Russian economy's vulnerabilities to external shocks. The Russian economy's dependence on natural resource extraction and exports contributed to its steep economic contraction, which, at 9.8% in the first quarter, is among the worst in the world.

¶3. (SBU) The energy sector has stagnated under the weight of government ownership and control. Due to excessive state

control, an onerous tax regime, and consequent under-investment in exploration and production, oil production is virtually stagnant and predicted to remain so, or even to decline, in the near- and medium-term. Gas production was similarly facing stagnation until the economic crisis and consequent plummeting demand, both at home and in export markets, resulted in major cutbacks in production.

14. (SBU) The GOR directly owns or controls almost the entire gas sector and much of the oil sector, including 100% of both the oil and gas pipeline infrastructure. A limited amount of oil leaves via ports, outside of direct government control, in Sakhalin and at Varandey on the Barents Sea. Opacity is the norm in Russia's energy sector and rumors and reports of corruption are widespread. The sector is generally considered inefficient by international standards and is decades behind in its uses of technology and management practices.

WINDOW OF OPPORTUNITY

15. (C) A Russian energy sector that does business in multiple markets in well-regulated jurisdictions will be less able to use its energy riches for political aims. Subject to regulatory oversight, partnered with established Western multinationals, and under the microscope of Western financial markets, Russian companies, whether state-owned or not, will be less able to contravene accepted international business principles. Subject to international competition for

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consumers and for capital, the sector would also have to become more responsive to the global energy markets, rather than seeking to control them. Your visit provides an opportunity for us to promote a modern, competitive, robust, and globally integrated Russian energy sector, and to find a constructive means of dialogue. Unfortunately, the run-up in oil prices in the last several weeks has undermined the sense of urgency that could serve as a catalyst for needed reforms.

16. (C) Deputy Prime Minister Igor Sechin, a proponent of state control of the economy in general and of the energy sector in particular, is the key decision maker on government energy policy. Like many of Prime Minister Putin's close allies, Sechin emerged from the security services. The USG has had virtually no interaction with him. Without access to Sechin and with limited access to other senior government decision makers in the energy sector, our "cooperation" on energy issues has been limited. Even with increased access, the state-centric structure of Russia's economy and especially its energy sector is very different from ours, and progress is therefore likely to be slow. While we are unlikely to influence Russia's energy policies significantly, we can help plant the seeds to nudge Russian energy policies in positive directions.

17. (C) Your visit will also help provide us important insights into Russia's goals and plans for the sector. Recent moves, publicly pushed by Putin himself, to lower the tax burden on the oil sector, to force third-party access to Gazprom's pipelines, and to raise domestic gas prices, are all welcome. Although these policies would only affect the long-term, you should applaud them as helping secure future additional energy supplies, and encourage a continued focus on these and other reforms intended to boost production, investment, and competition.

GAS PIPELINES

18. (SBU) Russian pipeline policy is to diversify away from transit states. The Nord Stream and South Stream projects are specific and very expensive attempts to realize this

policy. Regardless of its diversification plans, Russia will be dependent on selling gas to the European market for the foreseeable future and, importantly, on transit through Ukraine for gas exports. Some 80% of Russian gas exports to Europe transit Ukraine. Transit disputes with Ukraine are Gazprom's major source of frustration. While Russia's politicization of the gas trade grabs the headlines, lost in much of the analysis is an appreciation of Russia's dependence on European consumers. Russia is as dependent on Europe as a gas customer, perhaps more so, as Europe is on Russia as a gas supplier. The majority of Gazprom's vast revenues and profits come from sales to Europe.

¶9. (SBU) Another key consideration for Russian policy is Central Asia. Given stagnant production, Russia previously could not fulfill its European contracts and its various gas pipeline ambitions without Central Asian gas, particularly from Turkmenistan, the majority of whose gas exports go through Russia. However, the recent gas glut has meant that Gazprom has no immediate need for Turkmen gas, for which it was reportedly paying higher prices than it was charging its European customers. A recent trunk pipeline explosion in Turkmenistan halted Turkmen gas sales to Russia and this trade has not resumed despite the pipeline's repair. This disruption in Turkmen gas exports to Russia and the resulting tensions have helped push Turkmenistan to more eagerly look to diversify its own export options.

¶10. (C) In explaining our Eurasian energy policy to the GOR, we need to disabuse the Russians of the notion that this is a zero-sum U.S.-Russia competition. We should clearly demonstrate that our support for particular projects is based on their commercial viability.

USER GUIDE

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¶11. (SBU)

-- Gazprom: State-owned Gazprom, which evolved from the former Soviet Ministry of Gas, produces some 75%-85% of Russian gas and controls the gas pipeline infrastructure. The remainder of Russian gas is produced by so-called "independents", led by Novatek (partially owned by Gazprom), and by oil companies.

-- Rosneft: State-owned Rosneft vaulted from near obscurity to become the largest oil producer in Russia following the acquisition of former Yukos assets.

-- Transneft: Transneft is the 100% government-owned oil pipeline monopoly.

-- Lukoil: The largest private Russian oil company, Lukoil is a strategic partner of ConocoPhillips, which owns 20% of Lukoil.

-- TNK-BP: The third-largest Russian oil company, TNK-BP is owned 50-50 by BP and billionaire investors Mikhail Fridman and German Khan (Alfa Group), Viktor Vekselberg (Renova Group), and American citizen Len Blavatnik (Access Industries). The two sides recently settled a major and public dispute over control of the company. The settlement maintained BP's 50% ownership but diluted its control.

-- Gazpromneft: The fourth largest Russian oil company, Gazpromneft is Gazprom's oil subsidiary.

-- Surgutneftegaz: The fifth largest oil company, Surgutneftegaz is considered a particularly opaque company, and rumored to be partly owned by Prime Minister Putin.

THE AMERICAN PRESENCE IN THE SECTOR

¶12. (SBU) All U.S. majors have expressed to us an interest in working in Russia in the long-term. To that end, they seek, thus far with little success, access to strategic assets in which to invest. Their current investments, while among the largest of any foreign company in Russia, are not very large by the standards of international oil companies.

-- ExxonMobil owns 30% of the Sakhalin 1 integrated oil and gas project and is a partner in the CPC pipeline.

-- ConocoPhillips owns 20% of Lukoil, with which it is also a partner in Naryanmarneftgaz (NMNG). NMNG operates fields in West Siberia, from which it sends oil to the Varandey terminal, jointly owned by ConocoPhillips and Lukoil.

-- Chevron's investment in Russia is thus far largely limited to its interest in the CPC pipeline.

BEYRLE